Appendix 1

Glossary of accounting terms

The lexicon of accounting can seem extensive and confusing, and so it is helpful to have a concise summary. This is the spirit in which this glossary has been compiled. The definitions provided here are not technical and impenetrable, but instead informal and explanatory. So, for example, while several of the definitions are similar to those in international accounting standards, they differ wherever a more relaxed use of language helps to convey meaning.

Accounting The process of identifying, measuring and communicating economic information, with the purpose of informing decision making relating to the financial performance and financial position of an organisation.

Accounting policies The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Accounts payable, or creditors A liability comprising amounts for which an invoice has been received but cash settlement remains outstanding, for example arising as a result of purchases made on credit.

Accounts receivable, or debtors An asset comprising amounts that have been invoiced but cash has yet to be received, typically arising as a result of sales made on credit.

Accounts receivable turnover A ratio measuring the time taken to collect cash from customers. Accounts receivable result from revenue that has been recognised but not yet received in cash, and so a comparison of the outstanding accounts receivable balance at the end of a reporting period with the total revenue recognised during that period indicates how quickly revenue is converted into cash. Specifically, accounts receivable turnover is defined as (accounts receivable/annual revenue) × 365 days.

Accrual basis of accounting The effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

Amortisation The systematic allocation of the depreciable amount of an asset over its useful life. In effect, amortisation is an alternative term for depreciation. It is typically applied to intangible assets, while depreciation is applied to tangible assets.

Asset A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Associate An entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Balance sheet Financial statement that presents the relationship of an entity's assets, liabilities and equity at a point in time.

Book value The amount at which a given item is recorded in the balance sheet. An asset may have an actual, economic value that exceeds its book value, although the opposite should not, in principle, be the case. For example, the book value of land and buildings may be the amount that was originally paid on acquisition (historical cost), while the amount that could be realised on disposal (economic value) might be significantly greater. If, however, the economic value declines to an amount below the book value, then the latter should be written down, so that book value and economic value are equal.

Breakeven The level of output at which total income is equal to total expenses.

Budget A set of financial projections, typically for income and expenses, but also for capital expenditure and cash flow, which is, first, a financial representation of planned business activity and, second, a benchmark against which to control and evaluate realised business performance.

Business combination The bringing together of separate entities or businesses into one reporting entity.

Capital employed The total investment made by shareholders and debt holders of an organisation – i.e. the total value of equity plus debt.

Capitalise Expenditure is said to be capitalised, as opposed to expensed, when it leads to the creation of a new asset on the balance sheet. Hence, it is typical for a cash outflow classified as investing to be capitalised, while an operating cash outflow is expensed.

Carrying amount The amount at which an asset or liability is recognised in the balance sheet.

Cash flows Inflows and outflows of cash.

Cash flow statement Financial statement that provides information about the changes in cash of an entity for a period, showing separately changes during the period from operating, investing and financing activities.

Class of assets A grouping of assets of a similar nature and use in an entity's operations.

Component of an entity Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Consolidated financial statements The financial statements of a group of entities consisting of a parent and one or more subsidiaries.

Contingent liability (a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

Control (of an entity) The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Contribution The incremental effect on profit from a transaction with customers, equal to sales revenue less variable cost of making the sale.

Cost of capital The percentage return on capital that providers of finance expect to earn; also known as the cost of equity when applied to shareholders' funds, or the rate of interest when applied to the cost of debt finance. If a company is funded by both equity and debt finance, then its overall cost of capital is an average of the cost of equity and the interest rate, weighted by the proportions of equity and debt in the capital structure; this is known as the weighted average cost of capital, or WACC.

Cost of goods sold Expenses that are directly attributable to units of output, notably materials and other components of inventory.

Credit See double-entry accounting.

Creditors See accounts payable.

Current asset An asset that is expected to be converted into cash within one year, notably inventory, accounts receivable and cash.

Current liability A liability that is expected to be settled by cash payment within one year, notably accounts payable (to suppliers, tax authorities and so on) and short-term financing obligations.

Current ratio A measure of liquidity, equal to the ratio value of current assets to current liabilities.

Debit See double-entry accounting.

Debt A liability, representing finance provided to an organisation at a contractually agreed rate of interest. Debt and equity together comprise the capital employed by a company.

Debtors See accounts receivable.

Depreciable amount The cost of an asset less its residual value.

Depreciation The systematic allocation of the depreciable amount of an asset over its useful life. In effect, depreciation is an alternative term for amortisation. It is typically applied to tangible assets, while amortisation is applied to intangible assets.

Discontinued operation A component of an entity that either has been disposed of, or is classified as held for sale, and (a) represents a separate major line of business or geographical area of operations; (b) is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or (c) is a subsidiary acquired exclusively with a view to resale.

Discounting A method of converting cash flows expected to take place at various future dates into their equivalent present values.

Direct cost A cost that varies in direct proportion with output: any increase in output results in an extra direct cost.

Dividend A payment made by a company to its shareholders, as a distribution of profit earned by the company.

Dividend yield Defined as dividends per share divided by the share price, the dividend yield is a simple measure of the cash withdrawn from a company by shareholders as a percentage of the value of their investment. The sum of the dividend yield and the percentage increase in the share price (i.e. the percentage capital gain, excluding the amount paid out as dividend) measures the total return to shareholders during a period of time.

Double-entry accounting The underlying mechanism of record-keeping in accounting, whereby every transaction or event is recorded in the form of a journal entry, comprising a debit to one individual account and an equal credit to another. A debit entry is an increase in an asset, or a decrease in equity or in a liability. A credit entry is the opposite of a debit entry, such that the effect of a journal entry, in simultaneously debiting one account and crediting another, is to ensure that a balance sheet always remains balanced. The collective term for all individual accounts is the general ledger, and balances are drawn from the general ledger in order to present summary information in the financial statements.

EBIT, or operating profit Earnings before interest and tax; a measure of profit earned by an organisation's operating activities.

EBITDA Earnings before interest, tax, depreciation and amortisation; a measure of performance that is something of a hybrid between operating profit and operating cash flow, being based upon EBIT but excluding depreciation and amortisation, which are typically the largest accruals (non-cash items).

Economic profit A measure of profit that includes a notional cost for the use of shareholders' funds, sometimes referred to as economic value added, or residual income. A positive economic profit implies that the company is achieving a better return on shareholders' funds than could be achieved if those funds were invested elsewhere. Economic profit is therefore a measure of shareholder value creation.

Enterprise value The total economic value of a company, defined as the sum of shareholder value (market capitalisation) and the market value of debt, which equals the economic value of the company's net assets.

eps (earnings per share) Profit after tax/number of shares in issue; used primarily in the PE ratio.

Equity The residual interest in the assets of the entity after deducting all its liabilities.

Expenses Decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Fair value The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Financial accounting The external reporting of the financial statements and related information, primarily for the purpose of the organisation's providers of finance.

Financial asset Any asset that is: (a) cash; (b) an equity instrument of another entity; (c) a contractual right to receive cash or another financial asset.

Financial instrument A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial liability Any liability that is a contractual obligation to deliver cash or another financial asset to another entity.

Financial position The relationship of the assets, liabilities and equity of an entity as reported in the balance sheet.

Financial statements Structured representation of the financial position, financial performance and cash flows of an entity.

Financing activities Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity, reported as a category in the cash flow statement.

Fixed assets Assets held for ongoing use within the business, with an expected life exceeding one year.

Fixed costs Costs that do not vary with output during a specified period of time.

GAAP Generally accepted accounting practice – i.e. the set of rules and regulations that make up accounting standards for external financial reporting.

Gains Increases in economic benefits that meet the definition of income but that are not revenue.

Gearing See leverage.

General ledger See double-entry accounting.

Going concern An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

Goodwill Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

Gross profit A subtotal in the income statement, equal to revenue less cost of goods sold, typically expressed as a percentage gross profit margin.

IRR (internal rate of return) The average economic rate of return earned over the life of an investment. If the IRR is equal to the cost of capital, then the investment has a net present value of zero, because the amount that is earned is equal to the return expected by investors. If the IRR exceeds the cost of capital, then value is created.

Indirect cost A cost that does not vary in direct proportion with output.

Impairment loss, or write-down The amount by which the carrying amount of an asset exceeds its economic value.

Income Increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Income statement Financial statement that presents information about the performance of an entity for a period, i.e. the relationship of its income and expenses.

Intangible asset An identifiable non-monetary asset without physical substance. Such an asset is identifiable when it: (a) is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Interim financial report A financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period (i.e. a financial reporting period shorter than a full financial year).

International Financial Reporting Standards (IFRSs) Standards and Interpretations adopted by the International Accounting Standards Board (IASB).

Inventory, or stock An asset: (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventory turnover A ratio measuring the holding period for inventory, defined as (inventory/annual cost of sales) $\times$ 365 days.

Investing activities The acquisition and disposal of long-term assets and other investments, reported as a category in the cash flow statement.

Investment property Property (land or a building, or part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business.

Journal entry See double-entry accounting.

Leverage, or gearing (financial) The relationship between debt and equity in a company's capital structure, defined as debt/capital employed. High financial leverage implies relatively high variation in ROE resulting from variation in ROCE.

Leverage, or gearing (operating) The relationship between variable costs and fixed costs, defined as fixed costs/total costs. High operating leverage implies relatively high variation in profit resulting from variation in output.

Liability A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Liquidity Nearness to cash. An asset or liability is said to be more liquid if it can be more readily converted into cash, meaning converted more quickly and at relatively little risk of change in value.

Loans payable Financial liabilities other than short-term trade payables on normal credit terms.

Management accounting The reporting of the financial statements and related information within an organisation, for the purposes of decision making by management.

Market capitalisation, or shareholder value The value on the stock market of the publicly traded equity of a company, defined as share price × number of shares.

Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Measurement The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement.

Net assets The total value of assets less liabilities. Net assets in the balance sheet must be equal to equity. If the value of net assets changes, then this is either because the organisation has: (a) made a profit or loss; or (b) received an additional investment from its shareholders or transferred funds to its shareholders.

Net operating profit after tax (NOPAT) Defined as operating profit × (1 – tax rate).

Net present value (NPV) Defined as the present value generated by an investment, less the cost of making that investment. An investment that has a positive net present value is by definition value-creating, meaning that it provides a better investment opportunity than would be otherwise available to investors.

Notes (to financial statements) Notes contain information in addition to that presented in the balance sheet, income statement, statement of changes in equity and cash flow statement. Notes provide narrative descriptions or disaggregations of items disclosed in those statements and information about items that do not qualify for recognition in those statements.

Objective of financial statements To provide information about the financial position, performance and cash flows of an entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

Operating activities The principal revenue-producing activities of the entity and other activities that are not investing or financing activities, reported as a category in the cash flow statement.

Operating profit See EBIT.

Operating segment An operating segment is a component of an entity: (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); (b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and (c) for which discrete financial information is available.

Opportunity cost The value foregone by choosing one course of action over another. If, for example, a given sum of money is used to purchase shares in a company, then it cannot be invested elsewhere, and the value foregone by not being able to invest elsewhere is the cost of not taking that opportunity. If the actual return exceeds the opportunity cost, then value is created.

Overhead Costs that are indirect, meaning that they do not vary in direct proportion with output. Such costs may be independent of variation in output, in which case they are fixed, or they may be related, in which case they are termed variable overheads.

PE ratio A valuation measure used by investors, typically when comparing one company with another, defined as the ratio of share price to earnings per share (share price/eps). If a company has a high PE ratio, then either: (a) it is expected to have high earnings growth; (b) it is perceived to be a low-risk investment; or (c) it is overpriced by stock market investors.

Performance The relationship of the income and expenses of an entity, as reported in the income statement.

Present value A current estimate of the present discounted value of future net cash flows.

Profit The residual amount that remains after expenses have been deducted from income.

Profit and loss account (P&L) See income statement.

Profit margin Profit expressed as a percentage of sales, typically either as a gross profit margin (gross profit/sales), operating profit margin (operating profit/sales) or net profit margin (profit after tax/sales).

Property, plant and equipment (PPE) Tangible assets that: (a) are held for use in the production or supply of goods or services, for rental to others, for investment or for administrative purposes and (b) are expected to be used during more than one period.

Provision A liability of uncertain timing or amount.

Prudence The inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

Realisation The process of conversion into cash. For example, when an asset such as a building or a holding of shares is sold, the value is said to be realised. If the value of asset has increased while in the possession of an organisation, but the asset remains on the balance sheet and has not yet been sold, then there is said to be an unrealised gain.

Recognition The process of incorporating in the balance sheet or income statement an item that satisfies the following criteria: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability.

Relevance The quality of information that allows it to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

Reliability The quality of information that makes it free from material error and bias and represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Reporting date The end of the latest period covered by financial statements or by an interim financial report.

Reporting period The period covered by financial statements, which for external financial reporting purposes is typically a quarter, half or full year.

Residual value (of an asset) The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Retained profit A component of equity, equal to the cumulative profit earned by a company less the cumulative dividends paid to shareholders; it is the amount of profit that has been earned and retained.

Return on capital employed (ROCE) Defined as either operating profit/capital employed or as NOPAT/capital employed; a measure of the rate of return on the total equity and debt investment in the company.

Return on equity (ROE) Defined as profit after tax/equity; a measure of the rate of return on shareholders' investment in the company.

Revenue The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Share, or stock An equity investment. A shareholder invests cash in a company in exchange for a percentage ownership (a share) of the equity of that company. Ownership of shares can be traded on a stock market.

Shareholder value See market capitalisation.

Statement of changes in equity Financial statement that presents the profit or loss for a period, items of income and expense recognised directly in equity for the period, the effects of changes in accounting policy and corrections of errors recognised in the period, and (depending on the format of the statement of changes in equity chosen by the entity) the amounts of transactions with equity holders acting in their capacity as equity holders during the period.

Stock See Inventory or Share.

Tax expense (tax income) The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Taxable profit (tax loss) The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)

Timeliness Providing the information in financial statements within the decision time frame.

Total shareholder return (TSR) The sum of the dividend yield and the percentage increase in the share price (i.e. the percentage capital gain, excluding the amount paid out as dividend).

Understandability The quality of information that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

Useful life The period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity.

Variable costs Costs that vary with output. Variable costs can be direct, if they vary in direct proportion with output, or they can be indirect (variable overheads), in which case the relationship with output is less straightforward.

WACC See cost of capital.

Working capital Defined as current assets less current liabilities (i.e. current net assets), working capital is a measure of the amount of finance needed to fund an organisation's operating cycle – i.e. it is the investment required for a given level of (in particular) inventory and accounts receivable, offset by the amount of accounts payable. Cash, bank overdrafts and other financing items can be excluded from working capital, on the basis that they relate to the financing of the organisation, as opposed to being an investment in its operations.

Write-down See impairment loss.